

House Committee on Financial Services

Hearing on monetary policy

February 16, 2007

James Grant
written statement

The Federal Reserve figuratively prints the thing we all want more of. Why so little of this manna seems to find its way into deserving pockets is at the top of today's agenda.

Under the law, the Fed has a dual mandate. It must protect against inflation, as defined, and promote full employment. But Congress and the American people have come to expect much more from our central bank than even that tall order. We ask, in addition, that it make an inherently risky world safe. We expect the Fed to deliver us from the consequences of hedge-fund explosions, sovereign-debt defaults, bear stock markets, bank failures, deflations and other financial and economic vicissitudes.

It can't be done. Goldman Sachs itself would blanch at the task. It's not that low inflation and high levels of employment are incompatible. They are not, I believe. The experience of the past 50 years assigns a pretty heavy burden of proof to any exponent of the so-called Phillips curve in any of its many guises. A little more inflation may bring forth (for a while) a little more employment. Much more dependably, a little inflation will deliver a little more inflation, and then a little more, and so forth, followed by much less employment.

The trouble with the Fed's mandate boils down to two obstinate facts. The first concerns inflation itself. It is not easy to define, let alone to control. "Too much money chasing too few goods" is familiar but incomplete. "Too much money, period," is better, though admittedly vague. What the money chases varies from era to era. In the 1970s, it was goods and services. More recently, it was houses (and office buildings and highly leveraged corporations, among other investment assets). The fact that we called this levitation of house prices something besides inflation does not alter the fact that a monetary disturbance changed the way millions of Americans lived and worked. Once upon a time, former chairman Alan Greenspan defined inflation as a change in prices sufficient to cause people to adjust their behavior. The house price bubble exactly conforms to that definition. It was a kind of inflation.

Obstinate fact No. 2 lies in the way the Fed goes about its work. It fixes an interest rate. This one and only policy instrument is a very blunt tool. What Pope Julius II did not say to Michelangelo was, "Here's your roller. Now go paint the ceiling of the Sistine Chapel." It is worse than that with the Fed, however, because a paint roller never

destroyed an industry or led directly to shortages of New York City apartments or disintermediated the nation's thrift institutions. So great is the Federal Reserve's prestige that it is easy to gloss over the essentially disreputable method by which it goes about its job. The fact is that the Fed—like the unreformed Texas Railroad Commission, the New York City rent-stabilization apparatus and the late, unlamented Interstate Commerce Commission and Civil Aeronautics Board—is in the business of price control.

Now I want to give credit where credit is due. The currency that the Fed sponsors is passed from hand to hand the world over. It is not the first dominant global monetary brand—the pound sterling ruled the roost in the 19th century and for a few decades of the 20th. But the dollar is the first universally honored irredeemable paper currency. Not since 1971 has anything tangible stood behind it. It is uncollateralized—faith-based—yet the world accepts it. It is America's greatest export. The United States consumes much more than it produces and discharges its foreign debts in money that it alone is allowed to print. If there were ever a golden age of paper money, this is it.

Perhaps out of respect for these wonderful facts, the financial world has suspended its disbelief about the Fed's operating method. Ask a Wall Street economist if the Department of Agriculture should set soybean prices or the Federal Energy Regulatory Commission gasoline prices, or whether the Fed itself should get back into the business of fixing bank deposit rates (as it did from 1933 to 1980), and your answer would be a disdainful stare. Yet these same believers in the efficacy of price discovery accept that the Fed can determine the correct federal funds rate. They go further: Having dreamt up the right rate, the Fed should impose it on the market.

Of course, people in markets are not infallible. Neither are people in bureaucracies incapable. Markets are not divinely ordered. But market judgments, however imperfect, are generally less imperfect than the decisions decreed from on high. It's true that the Fed does not impose its will without reference to markets. But, having taken the markets' pulse, the Fed sometimes decides that it knows better than they do. It so judged in 2002-03, and it seems to believe it again today. This is very thin ice on which the Fed is skating—on which we are all skating, the American wage earner not least.

The Fed was at its most unilaterally willful four years ago. You may recall that the Federal Open Market Committee was agitated about what it chose to call deflation. The stock market bubble had burst, there was a short recession (March-November 2001), the CPI had lost its bounce and employment growth was disappointingly sluggish. Japan had not yet rubbed the sleep out of its eyes from a decade-long economic hibernation. The risk of falling prices preoccupied our central bank.

The Fed had begun to chop away at its interest rate before the recession officially began. It was hard at it all during 2001. By the time the anti-deflation campaign reached full rhetorical strength, the funds rate sat at 1¼ percent, the lowest in decades. But it was still too high, the FOMC broadly hinted. Messrs. Bernanke and Greenspan vowed to do everything in their power to hold the inflation rate to a decent minimum, say 1½ percent

to 2 percent a year. And to what lengths would they go? “[T]he U.S. government has a technology called a printing press (or, today, its electronic equivalent),” said Mr. Bernanke in November 2002, “that allows it to produce as many U.S. dollars as it wishes at essentially no cost.” That left little enough to the imagination. Neither did the remarks of his then boss, Mr. Greenspan, who observed: “The Federal Reserve has authority to purchase Treasury securities of any maturity and indeed already purchases such securities as part of its procedures to keep the overnight rate at its desired level. This authority could be used to lower interest rates at longer maturities. Such actions have precedent: Between 1942 and 1951, the Federal Reserve put a ceiling on longer-term Treasury yields at 2½%.”

To some of us, these urgent warnings seemed misplaced. They were inconsistent not only with earlier Fed pronouncements, but also with common sense. In the late 1990s, the Fed could hardly stop talking about free trade and high productivity growth. They were unqualified blessings, it said. Digital technology was a time-and-motion man’s dream come true. The fall of communism and the rise of the Internet were opening previously shut-in labor markets in Asia and the former Soviet Union. The global supply curve was shifting downward and to the right.

The sum of these changes pointed strongly to everyday low, and lower, prices for tradable goods and services. Was this not a good thing? Not exactly, the Fed now decided. Once the inflation rate approached the zero mark, it might keep falling. And if prices actually fell, and kept falling, why would anyone go shopping today? They would wait for the sales tomorrow. And it must have weighed on Messrs. Greenspan and Bernanke that the U.S. economy was increasingly leveraged. Falling prices are good for consumers, bad for debtors. The United States itself had become a sizable debtor to the rest of the world.

Wall Street did not dwell overly long on the possible inconsistencies of the Fed’s anti-deflation policy. It focused instead on moneymaking. If Mr. Greenspan, a lifetime apostle of free markets, was now threatening to muscle 10-year yields down to as low as 2½ percent, it was an open invitation to buy bonds. Market interest rates, including mortgage rates, duly plunged.

Interest rates are the traffic signals of a market economy. Green, red or amber, they direct the speed and destination of investment capital. The solid green signals of the early 2000s channeled capital and labor into residential real estate. The influx transformed the character of the mortgage market. No more, it seemed, did home buyers have to apply for a loan. More and more, the lenders came to them, whoever they were. Newfangled mortgages—“affordability products,” as they were called—threw open the doors of home ownership to millions of formerly unqualified buyers.

The Fed’s low interest rates and the lenders’ ingenuity combined to bridge the gap between high house prices and not-always-high incomes. If a simple adjustable-rate mortgage could not close the deal, the bankers and brokers had other ideas. Option ARMs, deferred-interest loans and easily accessible junior liens meant that just about

nobody couldn't qualify. White lies, too, played their part in the drive toward universal home ownership. So-called low-documentation mortgages put the applicant on his or her honor. Income? Job title? Years of employment? Your word was your bond. Low-doc mortgages became especially popular among subprime buyers. In 1999, according to UBS mortgage research, just 21 percent of low-rated loans were closed with less than full documentation. In the past two years, fully 41 percent were. Wall Street gathered up these millions of new mortgages, packaged the collateral and modeled the cash flows to create asset-backed securities. The scale of this operation is one of the wonders of modern finance. Of all the residential mortgages outstanding in the United States, 80 percent were originated after 2002. Of all the subprime mortgages outstanding, 75 percent were originated after 2003.

Without this interest-rate-assisted mortgage boom (and credit-assisted consumption boom), job growth in the early 2000s might have been even more sluggish. As it was, according to Asha Bangalore, an economist at Northern Trust Co., housing-related employment generated 43 percent of all private-sector job creation from November 2001 to April 2005. As might be expected, this kind of work has been getting scarcer. Thus, from November 2001 to January 2007, and housing-related businesses have produced just 19 percent of all private-sector jobs. The famously adaptable U.S. economy is generating new opportunities.

Adaptability is a very handy quality these days, as the financial traffic lights are sometimes stuck on red or green, a source of confusion and the occasional financial pileup. Now is one of those difficult times. The Fed's interest rate, 5¼ percent, is the highest on the Treasury yield curve. The market seems to want a lower structure of interest rates, whereas the FOMC is prepared to push higher. The market appears to be less worried about inflation than about the unintended consequences of the mortgage bubble—i.e., rising delinquencies and foreclosures, a nasty downturn in the prices of some of the mortgage-backed securities created last year and the risk of contagion in the wider economy. The Fed, for now, will have none of it. It is worried about inflation but sanguine on the economy and the housing situation alike.

Pharmaceutical companies must disclose the side effects of the pills and medications they advertise, and the purveyors of monetary remedies should be held to a similar standard of candor. Once, at least, the FOMC seemed to own up to some of the unwholesome consequences of its radical intervention of 2001-04. "Some participants," said the minutes of the Dec. 14, 2004, FOMC meeting, "believed that the prolonged period of policy accommodation has generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers-and-acquisition activity and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums."

These concerns were well-founded, and two years later the "signs of potentially excessive risk-taking" are even more glaring. The subprime mortgage market, about which we are suddenly hearing so much, has its counterpart in the business world.

Speculative-grade corporations are borrowing heavily at concessionary interest rates and with ever less documentation. They, like the subprime mortgage borrowers of 2005 and 2006, seem to expect low rates to persist or—at the very least—that the capital markets will afford them some future opportunity to refinance their debts on terms just as advantageous as the ones they have recently secured. On the other hand, millions of subprime borrowers are discovering that sometimes interest rates go up, and asset prices go down.

The Fed owes its public a forthright accounting of the risks it runs with the policy it pursues. I mean the risk that it picks the wrong interest rate, one that sets in motion a train of adverse events unimagined by the people who imposed the rate in the first place. In all things economic and financial, the Fed is a force for what it likes to call stability. But few things are so ultimately destabilizing as a belief that the world is in for a long spell of peace and quiet.

The Fed, like a good physician, should first do no harm. And, like a good drug company, it should not withhold its warnings on side effects. In interest rates as in painkillers, the secondary reactions can be debilitating.